

October 1, 2003

The Honorable Mayor, Aldermen, and Citizens of Annapolis:

State law requires that all general-purpose local governments publish each fiscal year a complete set of financial statements presented in conformity with generally accepted accounting principles (GAAP) and audited in accordance with generally accepted auditing standards by a firm of licensed certified public accountants. Pursuant to that requirement and in compliance with Section 6.04.020 of the City of Annapolis Charter, I am pleased to submit to you the Comprehensive Annual Financial Report of the City for the fiscal year ended June 30, 2003.

This report consists of management's representations concerning the finances of the City of Annapolis. Consequently, management assumes full responsibility for the completeness and reliability of all of the information presented in this report. To provide a reasonable basis for making these representations, management of the City has established a comprehensive internal control framework that is designed both to protect the City's assets from loss, theft, or misuse and to compile sufficient reliable information for the preparation of the City's financial statements in conformity with GAAP. Because the cost of internal controls should not outweigh their benefits, the City's comprehensive framework of internal controls has been designed to provide reasonable rather than absolute assurance that the financial statements will be free from material misstatement. As management, we assert that, to the best of our knowledge and belief, this financial report is complete and reliable in all material respects.

The City's basic financial statements have been audited by Lindsey and Associates, LLC, a firm of licensed certified public accountants. The goal of the independent audit was to provide reasonable assurance that the financial statements of the City of Annapolis for the fiscal year ended June 30, 2003, are free of material misstatement. The independent audit involved examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements; assessing the accounting principles used and significant estimates made by management; and evaluating the overall financial statement presentation. The independent auditor concluded, based upon the audit, that there was reasonable basis for rendering an unqualified opinion that the City's financial statements for the fiscal year ended June 30, 2003, are fairly presented in conformity with GAAP. The independent auditor's report is presented as the first component of the financial section of this report.

The independent audit of the financial statements of the City of Annapolis was part of a broader, federally mandated "Single Audit" designed to meet the special needs of federal grantor agencies. The standards governing Single Audit engagements require the independent auditor to report not only on the fair presentation of the financial statements, but also on the audited government's internal controls and compliance with legal requirements, with special emphasis on internal controls and legal requirements involving the administration of federal awards. These reports are available in the City's separately issued Single Audit Report.

GAAP requires that management provide a narrative introduction, overview, and analysis to accompany the basic

financial statements in the form of Management's Discussion and Analysis (MD&A). This letter of transmittal is designed to compliment MD&A and should be read in conjunction with it. The City of Annapolis' MD&A can be found immediately following the report of the independent auditors.

Profile of the Government

The City of Annapolis, incorporated in 1708, is situated on the western shore of the Chesapeake Bay, at the mouth of the Severn River, centrally located east of Washington, D.C. and south of the City of Baltimore. Due to this desirable location, as well as its historic charm, Annapolis has grown steadily during the past few years. Even though the City has little undeveloped land available, continued growth is expected through annexation and re-development.

The City of Annapolis is empowered to levy a property tax on real property located within its boundaries. The City of Annapolis operates under a mayor-council form of government. Legislative authority is vested in an elected city council consisting of eight members. The city council is responsible, among other things, for passing ordinances, adopting the budget, appointing committees, and confirming the hiring of department head nominees submitted by the mayor. The mayor is responsible for carrying out the policies and ordinances of the city council, for overseeing the day-to-day operations of the City, for drafting the budget and submitting it to city council for approval, and for appointing department heads. The mayor and all eight city council members are elected every four years with a term limit of two terms. The mayor is elected at large and city council members are elected from individual districts within the city.

The City has independent jurisdiction over police services, fire suppression and emergency services, inspections and permits, streets and street lighting, storm drains, parks and recreation, planning and zoning, water production and distribution, sewage collection, off street parking and public transportation, and refuse collection. Education is provided by the Board of Education of Anne Arundel County. The City is authorized to issue debt, subject to certain indebtedness limitations, for the purpose of financing its capital projects.

The annual budget serves as the foundation for the City of Annapolis's financial planning and control. All departments of the City of Annapolis are required to submit requests for appropriation to the mayor. The mayor uses these requests as the starting point for developing the proposed budget. The mayor then presents this proposed budget to the city council for review. The city council is required to hold public hearings on the proposed budget and to adopt a final budget no later than June 30. The appropriated budget is prepared by fund and department (e.g., police). Department heads may make transfers within a department. Transfers of appropriations between departments, however, require the special approval of the city council. Budget-to-actual comparisons are provided in this report for each individual fund for which an appropriated annual budget has been adopted. For the general fund, this comparison is presented on page 26 as part of the basic financial statements. For individual funds with appropriated annual budgets, this comparison is presented in the combining and individual fund subsection of this report, which starts on page 57.

Factors Affecting Financial Condition

The information presented in the financial statements is perhaps best understood when it is considered from the broader perspective of the specific environment within which the City of Annapolis operates.

Local economy. The City of Annapolis currently enjoys a favorable economic environment and local indicators point to continued stability. Annapolis' tourism industry has evolved as the most important, dynamic component of the Annapolis area economy. As home to the U. S. Naval Academy, the Anne Arundel County seat, the State capital, a registered National Historic District, and 17 miles of waterfront, Annapolis attracts an estimated five million visitors a year. While the tourism industry provides a valuable economic benefit, the City must continually manage the growing demand for services, as well as provide a desirable place to live for its residents. The economic condition of the area during the past year was positive and the outlook is the same. Property tax valuations and revenues both grew, increasing significantly over the previous year. The area unemployment rate is currently 3.4%, significantly better than the national rate of 6.1% and the statewide rate of 4.2%. The region's growth and economic diversity are expected to be the basis for continued health of the local economy in coming years.

Long-term financial planning. The City's capital improvement and economic development effort continues on the inner West Street corridor. Park Place, a multi-use project situated on seven acres at the end of the corridor, has started grading work and a Tax Increment Financing bond issue authorized by the City and the County is pending final financing arrangements by the developer. The City has completed two-thirds of the major project for the replacement of water and sewer lines as well as the under-grounding of the overhead utility lines and an improved streetscape. The final stage will be started and completed by Summer, 2004. The City's new parking facility is under construction and should be completed within fifteen months.

The private sector participation in redevelopment has been spurred by the City's commitment to revitalization. In addition to Park Place, a new 120 room hotel has opened and one project with Class A office space is being leased, a second Class A office with a banking center is underway, while a third is in the planning and permitting process. The hospital has completed its move to expanded facilities outside the City and the City has approved the planned mixed-use redevelopment of the property. Occupancy should occur within approximately two years.

In December 2002, \$20,885,000 of Public Improvement Bonds were issued for the purpose of funding the parking garage, road construction, an addition to Police headquarters, water and wastewater projects, and new fire fighting equipment. The City received its highest ever bond rating of "AA+", while obtaining the lowest interest rate in recent history.

In June 2003, \$7,690,000 of Refunding Bonds were issued to advance refund \$7,040,000 of outstanding Series 1993, 1994, and 1995 bonds. This transaction will result in reduced debt service payments over the next 12 years and have an economic gain of approximately \$650,000.

Cash management policies and practices. Cash temporarily idle during the year was invested in obligations of the U.S. Treasury, repurchase agreements, the State of Maryland Local Government Investment Pool, and in the case of the Police and Fire pension fund, corporate equity and debt securities, bonds, money market funds, and real estate.

Risk management. The city is self insured for automobile, property, and workers' compensation. Excess insurance is also carried with the Local Government Insurance Trust and has deductibles that vary with the cause of loss. Additional information on the City's risk management activity can be found in Note 15 of the notes to the financial statements.

Pension and other post-employment benefits. Generally, all regular City employees, except policemen and firemen, participate in the Employees Retirement and Pension Systems (Systems), cost sharing multiple-employer defined benefit plan sponsored and administered by the State Retirement and Pension System of Maryland. Police and fire personnel participate in a single employer defined benefit pension and disability plan, which is administered by the City's human resources director. In addition, the City established an eight-member police and fire retirement plan commission to review funding and actuarial reports and to make investing decisions. The City Council has the authority to establish and amend benefit and contribution provisions. The Systems were created by the Maryland General Assembly and the Police and Fire System was established by City legislation.

The City of Annapolis also provides post-retirement health care benefits for retirees and their dependents. As of the end of the current fiscal year, there were 8 retired employees receiving these benefits, which are financed on an actuarial basis. GAAP currently does not require governments to report a liability in the financial statements in connection with the employer's obligation to provide these benefits. Additional information on the City of Annapolis's pension arrangements and post-employment benefits can be found in Notes 8 and 9 in the notes to the financial statements.

Awards and Acknowledgements

The Government Finance Officers Association (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the City of Annapolis for its comprehensive annual financial report (CAFR) for the fiscal year ended June 30, 2002. This was the fifteenth consecutive year that the City of Annapolis has received this prestigious award. In order to be awarded a Certificate of Achievement, the city published an easily readable and efficiently organized CAFR. This report must satisfy both GAAP and applicable legal requirements.

A Certificate of Achievement is valid for a period of one year only. We believe our current CAFR continues to meet the Certificate of Achievement Program's requirements, and we are submitting it to the GFOA to determine its eligibility for another certificate.

In addition, the City also received the GFOA's Award for Distinguished Budget Presentation for its annual budget for the fiscal year beginning July 1, 2003. In order to qualify for the Distinguished Budget Presentation Award, the city's budget document was judged to be proficient in several categories including as a policy document, a financial plan, an operations guide, and a communications device.

Preparation of this report would not have been possible without the dedicated and efficient service of the entire staff of the finance department. I would like to express my appreciation to all members of the department who assisted and contributed to the preparation of this report. Credit must also be given to the mayor and city council for their unfailing support for maintaining the highest standards of professionalism in the management of the City of Annapolis' finances.

Respectfully submitted,

Timothy E. Elliott
Director of Finance